

# **EXHIBIT M**



## **Fitch Rates Puerto Rico PBA's \$650MM Guaranteed Bonds 'BBB+'; Outlook Stable**

Fitch Ratings-New York-05 June 2012: Fitch Ratings assigns a 'BBB+' rating to the following guaranteed bonds of the Puerto Rico Public Building Authority:

--\$650.44 million government facilities revenue refunding bonds, series U, guaranteed by the Commonwealth of Puerto Rico (the commonwealth).

The bonds are expected to sell by negotiation on June 6, 2012

Fitch also affirms the 'BBB+' ratings on the following outstanding bonds:

--\$725 million government facilities revenue bonds issued by the Puerto Rico Building Authority and guaranteed by the commonwealth;

--\$9.8 billion commonwealth general obligation (GO) bonds.

The Rating Outlook is Stable.

**SECURITY:** The bonds are secured by lease rental payments from government agencies and municipalities of the commonwealth, further secured by a guarantee by the commonwealth to draw from any funds available in the Treasury. The full faith and credit of the commonwealth is pledged to such deficiency payments resulting in a rating that is the same as the commonwealth's GO bonds.

### **KEY RATING DRIVERS**

**IMPROVED FINANCIAL MANAGEMENT:** Financial operations historically have been weak with a record of budgetary and GAAP deficits, overestimation of revenues, unfunded overspending, and a reliance on borrowing to meet budgetary gaps. Recent performance, however, is improved with better revenue estimating and budgetary controls.

**FISCAL STABILIZATION PLAN A POSITIVE CREDIT FACTOR:** The government has taken dramatic steps to restructure fiscal operations and stimulate the economy. The fiscal stabilization plan, with its emphasis on reduced government spending, was designed to close the structural gap over the course of three fiscal years. Continued progress in the fiscal stabilization plan is a positive credit factor.

**STILL LOOKING FOR ECONOMIC GROWTH TO TAKE HOLD:** The commonwealth's economy, which is limited but closely linked to the U.S. economy, is beginning to emerge from five years of recession. The downturn in Puerto Rico started earlier, was deeper, and lasted longer than the U.S. national recession. There are signs the economy is beginning to stabilize and modest growth is expected in FY 2012.

**HIGH DEBT LEVELS:** Debt levels are very high, partially reflecting the consolidated nature of the central government's role, and have increased as the commonwealth has used deficit financing as part of its fiscal stabilization plan.

PENSION FUNDING REMAINS A CHALLENGE. Pension funding is exceptionally low and, absent continued significant action, the main pension fund will run out of resources within a few years. Recently enacted changes to the pension plan, including annual increases in government contributions, will positively affect funding over time but will be an increased spending pressure.

#### WHAT COULD TRIGGER A RATING ACTION

**TRIGGER FOR NEGATIVE RATING ACTION:** Meaningful divergence from the fiscal stabilization plan that leads away from structural balance in the budget.

**TRIGGER FOR POSITIVE RATING ACTION:** Trend of positive economic performance and budgetary balance, as well as additional steps to stabilize pension funding.

#### CREDIT SUMMARY:

The 'BBB+' rating on the bonds reflects the full faith and credit guarantee by the Commonwealth of Puerto Rico. The commonwealth's Secretary of Justice has opined that the strong GO pledge, under which public debt has a first lien on available Commonwealth resources, applies to the guarantee. As a result, guaranteed bonds are rated the same as GO bonds. To date, no payments have been required from the commonwealth under the guarantee act. Puerto Rico's GO rating reflects the somewhat limited nature of its economy, its strong ties to the U.S., lingering economic weakness, a history of weak financial operations, and very high liabilities including outstanding debt and unfunded pensions. The significant progress the current administration has made in implementing fiscal and economic reform is a positive credit factor. Strong legal provisions for GO debt include a constitutional first claim on commonwealth revenues, including transportation-related and rum excise tax revenues that are dedicated to specific authorities and other bonds.

The current administration has taken significant action to restructure the budget amidst the prolonged recession and has demonstrated its willingness and ability to make significant changes to fiscal operations. It has successfully enacted legislation to implement both temporary and permanent revenue enhancements, stepped up revenue collection enforcement, and dramatically reduced public spending. The fiscal stabilization plan, with its emphasis on reduced government spending, was designed to close the structural gap over the course of three fiscal years, through fiscal 2012. Progress toward structural balance has been achieved; however, there has been significant use of deficit borrowing under the sales tax backed (COFINA) credit and debt restructuring for fiscal relief during the transition period and additional debt restructuring is proposed to balance the fiscal 2013 budget.

The commonwealth has enacted tax and pension reform, both intended to achieve longer-term structural balance. The tax reform initiative, the final piece of which was passed by the legislature in January 2011, is designed to replace revenues lost through significantly lower personal and corporate income tax rates with a temporary excise tax on certain manufacturers and ultimately by implementation of a source income rule for multi-national corporations. The restructuring of the tax system is intended to stimulate the economy and promote private sector investment by providing tax relief to individuals and corporations, simplifying the tax system, and reducing tax evasion. The loss of income tax revenue has been more than offset by a temporary excise tax on transactions between manufacturers and distributors that are members of the same non-resident holding or control group that produce in Puerto Rico. The excise tax, enacted in December 2010 as Act 154 and effective Jan. 1, 2011, includes tax credits for the affected companies that maintain employment at at least 90% of the current level, and will be phased out by fiscal 2016 when it is replaced by the income from the source income rule.

Despite strong performance of the new excise tax to date, there remains risk that the tax reform plan will not generate sufficient revenues to offset the loss of income tax revenues and ultimately will not result in a structurally balanced budget as planned. This concern is mitigated in part by a requirement that tax reductions

beyond fiscal 2014 meet a three-pronged test of fiscal and economic growth, which includes targets for expense controls, general fund net revenues, and growth in gross national product (GNP). It is also Fitch's expectation that management will take additional action to balance the budget should revenues not materialize as anticipated. Excise tax revenues in the first year of collection were above estimate and more than offset the reduction in personal and corporate income tax revenue. Strong revenue collection has continued in fiscal 2012 with revenues through April \$182 million (15.2%) above estimate.

The enacted budget for fiscal 2012 is based on a 5.9% increase in revenues, reflecting the full year implementation of the excise tax and strong growth in sales tax revenues, in part due to increased collections and enforcement efforts. There is increased spending for public safety, revenue sharing with municipalities, and pension contributions while welfare, health, and administrative expenses are slightly reduced. A structural budget gap remains although it is smaller than in previous years. The budget closed this remaining gap through issuance of \$610 million of sales tax bonds by COFINA and GO and guaranteed debt restructuring. Revenues through April 2012 are just slightly below the estimate (1.3%) and have increased year-over-year, reflecting in part the implementation of the excise tax. Revenues are meeting estimate for the fourth consecutive fiscal year, a positive factor given the commonwealth's recent history of weak revenue estimating that contributed to unexpected budgetary gaps. The governor's budget proposal for fiscal 2013 assumes modest 1.1% economic growth, continued expenditure controls, \$750 million in debt restructuring for budget savings, \$100 million of additional COFINA borrowing, and use of \$233 million released from a contingency fund derived from the refunding of variable rate debt and termination of an associated swap agreement.

The commonwealth's economy is showing signs of emerging from five years of recession, a downturn which started earlier, was deeper, and lasted longer than the U.S. national recession. Commonwealth GNP began to contract in fiscal 2007 and fell 4% and 3.8% in fiscal 2009 and fiscal 2010 respectively. Modest expansion had been predicted for fiscal 2010 with the federal and commonwealth stimulus plans expected to offset the steep workforce reductions associated with the fiscal stabilization plan. This expansion was not realized and the economy continued to contract through fiscal 2011. Indicators that the economy is finally beginning to stabilize include some growth in employment, increasing retail sales, rising home sales, strong tourism activity and decreasing bankruptcies. A modest 0.9% expansion is projected for fiscal 2012 followed by 1.1% in fiscal 2013. Over the course of the recession, Puerto Rico has lost over 100,000 jobs (approximately 10% of non-farm employment); the unemployment rate, which is typically much higher than the U.S. national rate, peaked at 16.6% in May 2010 and was 14.8% in April 2012. Steep losses in employment have abated, but growth remains sporadic. After two months of 0.4% growth in non-farm employment at the beginning of the calendar year, employment dropped again in March (-0.3%) and April (-0.7%).

Debt levels are very high, partially reflecting the consolidated nature of the central government's role, and have increased as the commonwealth has used deficit financing as part of its fiscal stabilization plan. Net tax supported debt is approximately 76% of 2010 personal income and over \$12,000 per capita. The commonwealth utilizes a complex debt structure that includes GO, sales tax, guaranteed, and public corporation debt. After a concerted effort to reduce exposure to variable rate debt, approximately \$588 million of variable rate general obligation debt remains outstanding. The commonwealth continues to actively pursue several strategies to address expiring liquidity facilities, including renewal and replacement, remarketing in fixed rate mode, and refunding with fixed rate debt, and has significantly reduced this exposure. The commonwealth benefits from its relationship with the Government Development Bank for Puerto Rico, which provides a degree of flexibility and liquidity. GO amortization is a slow 16% and 43% in five and 10 years, respectively.

Pension funding is exceptionally low; as of June 30, 2010, the Employees Retirement System (ERS) had a funded ratio of just 6.8%, with an unfunded accrued actuarial liability (UAAL) of \$23.7 billion (40% of 2010 personal income). The main pension fund, which is closed, is projected to deplete its assets by fiscal 2019 under current funding and disbursement trends. System contributions are defined by law rather than by actuarial requirements and payments have not been covering the actuarially determined annual required

contribution or even current benefit payments, which have exceed contributions and investment income since 2004. Shortfalls have been covered with loans, sale of assets, and pension bond proceeds issued in 2008. Recently enacted legislation begins to address the longer term funding of the system, with a one-time deposit of \$162 million and a requirement to incrementally increase contributions 1% per for five years followed by 1.25% per year for the subsequent five years. By the end of the 10-year ramp up period, pension contributions will have increased from 9.3% of compensation to 20.5%. The commonwealth will cover the increased cost for municipalities for the first three years and has included this additional expense in the fiscal 2012 budget. Despite limitations imposed by ongoing weakness in the economy, narrow financial operations, and already high debt levels, it is Fitch's expectation that the government will remain committed to rectifying the pension funding problem.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:

- 'Tax-Supported Rating Criteria', dated Aug. 15, 2011;
- 'U.S. State Government Tax-Supported Rating Criteria', dated Aug. 15, 2011.

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Tax-Supported Rating Criteria  
U.S. State Government Tax-Supported Rating Criteria

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